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NOTE FOR: Director of Central Intelligence

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You may find this memo useful as background for your worldwide briefing, even though I did not prepare it for that purpose.

Maurice C. Ernst

Attachment:
"Major Contingencies for the World Economy in 1984"

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Major Contingencies for the World Economy in 1984

Basic Economic Trends

1. The main economic trends for 1984 are reasonably well established. Unlike 1983, when the timing of the cyclical turning point was uncertain, 1984 almost certainly will be a year of cyclical upswing. This upswing, which began in 1983 in the United States, should spread to most other countries and gather momentum, even if US economic growth slows down. Moreover, with commodity prices likely to remain fairly depressed, and with unemployment and excess plant capacity in most countries remaining high, inflation should continue to moderate. The prospects for major countries and groups of countries appear as follows:

- US GNP growth of 4 to 5 percent, with inflation in the same range, interest rates about constant, and a dramatic increase in the current account deficit, as a result of the earlier rise in the dollar.
- More rapid growth in Western Europe than in 1983, with an accelerating West German recovery and the US expansion acting as the prime movers, but France and most of Southern Europe continuing to be depressed, because of earlier policy errors.
- Some acceleration of economic growth in Japan.
- A strong economic performance in the well-managed Asian LDCs, notably South Korea, Taiwan, and Singapore, which made their adjustments to the recession early and are now in an excellent position to take advantage of rising foreign demand.
- Continued severe depression in much of Latin America and Africa because of the overhang of the debt problem. Although export earnings will increase, import capacity in most countries will stagnate at low levels because of a reduced net flow of foreign capital and the need to rebuild depleted foreign exchange reserves.
- The major oil exporting countries will have to make further cuts in development programs, and in some cases in living standards, because of continued weak oil demand and the exhaustion of reserves or borrowing capacity.
- The Soviet economy will probably continue to expand slowly at a rate of 2 to 3 percent.
- Economic recovery will begin to pick up steam in Eastern Europe, where most economies have largely completed internal adjustments to the recent debt crisis and in addition can take advantage of growing Western demand for their exports.

Main Contingencies

2. Although the main macroeconomic forces appear reasonably well established for 1984, the international economy could be substantially affected by several possible developments, including especially:

- a large decline in the dollar;
- a substantial increase in interest rates;
- a major debt crisis involving default or basic renegotiation of debt service terms for major LDCs.
- a large increase or decline in oil prices.

A decline in the dollar

3. No one knows when the expected depreciation of what is widely considered an overvalued dollar will come. It was supposed to come last year, but did not. Most economists expect the dollar to decline this year, but traders are more cautious, having bet several times on this belief, and been burned badly. Still, few expect the dollar to go up and the growing US current account deficit should add to the downward pressure. At the same time, the incentive to use the dollar as a "safehaven" could increase or decrease, depending on economic and political conditions. If the dollar does decline substantially, there will be little short-term impact on US exports, but price effects will come quickly. Specifically:

- US inflation will increase;
- The prices of primary products, except probably oil, will go up in terms of dollars, which will benefit most LDCs.
- Oil prices probably will remain the same in terms of dollars, which means that they would drop in terms of most other foreign currency.
- Interest payments on international debt will change little (unless the dollar declined because of lower US interest rates) because most loans are made in dollars.
- Consequently, most LDC debtors would experience a marked easing in their debt service burden (debt service would fall as a share of export earnings).

Higher interest rates

4. While the lower dollar would quickly benefit most LDC debtors, a rise in interest rates would hurt them badly. LDC interest payments have about leveled off, with the impact of lower nominal interest rates being offset by that of increased debt. Higher interest rates once again would

increase the debt service burden unless export earnings were increasing more rapidly. Higher interest rates also would slow the economic recovery in the US and other industrial countries, which indirectly would depress demand for and prices of primary products.

A major debt crisis

5. There is a substantial risk in 1984 that some major LDC debtors will become unable or unwilling to meet their interest obligations, resulting either in default or in fundamental renegotiation of debt service terms. As the Financial Times points out in a perceptive article which draws parallels with the 1930s, the tendency of debtor governments to get tough with creditors, even to the point of default, seems to be greatest when their economies begin to recover. In 1984, most debtor countries will be in the early stages of economic recovery from extremely depressed conditions. In many countries, notably Brazil, Argentina, and Venezuela, the scope for recovery will be very small because the likely growth of export earnings will be largely offset by declining net capital inflow and in some cases by the necessity to rebuild some foreign exchange reserves. Despite IMF-mandated economic programs, banks apparently are becoming less and less willing to increase their exposure, and consequently the size of current account deficits that can be financed is shrinking. With import capacity narrowly constrained with political reactions to continued severe economic depression building and in some countries getting better organized, it will be extremely difficult for debtor countries to implement IMF-mandated programs designed to bring internal finances into balance with external payments possibilities. Politicians will grow increasingly impatient to get the economy moving again. Economic austerity, accepted at first because, with foreign exchange supplies exhausted, there was no other choice, will be increasingly resented the longer it lasts, and the IMF and foreign creditors will be accused of imposing foreign solutions and blocking national recovery.

6. A confrontation with the creditors is most likely to occur in Argentina or Brazil. Such a confrontation would probably include a refusal to pay interest unless debt service terms were substantially eased--for example, limiting interest payments to a certain share of export earnings. Failing agreement, default would ensue, requiring major action by Western central banks to maintain liquidity and prevent serious damage to the financial system. In the event of agreement on easier terms with one major country, at least many of the other debtors would insist on similar terms. This would threaten the solvency of many banks unless regulatory adjustments could be made quickly. Obviously, the odds on a debt crisis would be greatly increased if and when the Western economic recovery were aborted, particularly if interest rates had risen. But the risks of such a crisis are substantial even in a period of fairly rapid economic recovery.

Large oil price changes

7. Basic oil market trends for 1984 indicate that Saudi Arabia will probably continue to support a base price of $29 a barrel if it continues to get substantial cooperation from several other OPEC countries in holding down production. This means the real price of oil will continue to erode, the more so if the dollar falls. There are substantial risks, however, of large oil price declines or increases. On the downside, growing economic and political pressures in some OPEC countries, notably Nigeria, will probably induce them to raise oil production. This will force Saudi Arabia to reduce its already low production even further, except in the unlikely event that other OPEC countries are willing to accept cuts in their own quotas. If the Saudis refuse to accommodate, oil prices will fall and, in the absence of any new agreement, prices could fall very far--even to $15 a barrel. Prices could not stay at such low levels for long because oil demand would be stimulated strongly. But until the market stabilized, oil exporting countries would suffer major revenue losses and prevailing uncertainty would make banks even less willing to increase their exposure in developing countries. Moreover, investment in oil and gas throughout the world would collapse. On the upside, there is the possibility that an escalation of the Iran-Iraq War would stop or substantially reduce the flow of oil from the Persian Gulf, resulting in a major temporary surge in world oil prices, with negative effects on industrial countries and most LDCs alike.